

Shares from a very long-term perspective



Key points

- While the short-term outlook for shares is uncertain, they are great value from a very long-term perspective.
- The 50% plus slump in shares from last year's highs has taken them well below their long-term trend. Shares are trading on dividend yields normally associated with above average returns over subsequent 10-year periods.

Introduction

The short-term outlook for shares right now is almost anyone's guess. On the one hand, they are highly oversold and due for a strong bounce at least. They should also benefit from all the government stimulus being thrown at economies around the world. On the other hand, the economic outlook is characterised by greater than normal uncertainty. This is a result of the unprecedented disruption to the global financial system and its flow on to the economic outlook, given the high level of debt amongst investors, financial organisations and households in key countries. ¹ However, notwithstanding the short-term uncertainty for shares, it is worth putting the slump in a long-term historical context.

Up there with the worst

Firstly, the bad news is that as far as major bear markets go, this one is up there with the worst. The 52% fall in the US share market since its high in October last year to its recent low is the third worst bear market since 1900. It ranks only behind the bear market of 1929-1932 where US shares fell by 85%, and that of 1937-1942 where US shares fell by 60%. Similarly, the 51% fall in Australian shares from its November high last year to its recent (closing) low is the second worst bear market since 1900. It lags only behind the January 1973 to September 1974 bear market which saw shares fall 59.3%. Even the bear market associated with the Great Depression in Australia only saw shares fall 46% from a high in 1929 to a low in 1930 (although this is based on monthly data).

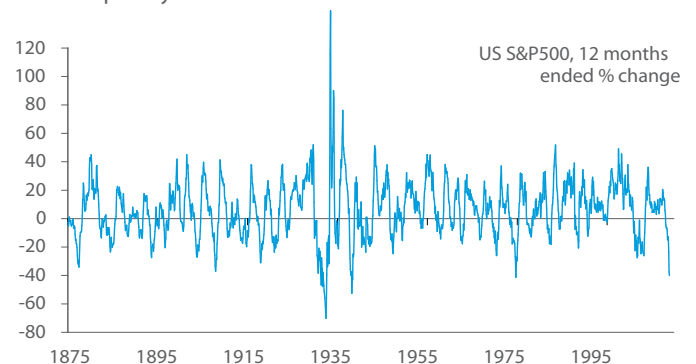
Rolling 12-month falls have rarely been worse

The next two charts look at this from another perspective. They show the rolling 12-month ended price changes for US and Australian shares from 1875. Both markets have seen percentage falls over the last 12 months of a magnitude rarely seen in the past. In fact, only in the 1930s, associated with the Great Depression and World War II, and in the 1970s, associated with

¹ The uncertain economic outlook was discussed last week. See 'How deep is the recession?', *Olivers Insights*, November 2008.

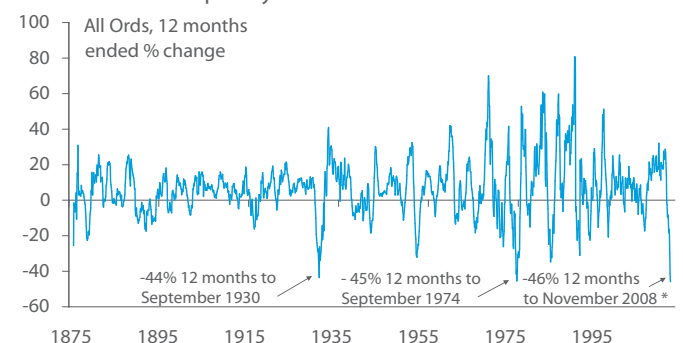
stagflation, has the rolling 12-month fall been comparable to what has been seen over the last year. We are now at, in the case of Australian shares, or approaching, in the case of US shares, historical extremes. Another interesting observation that can be made from the charts below is that after such huge falls, shares normally rebound in subsequent years.

US shares – extreme falls are often followed by extreme rebounds in subsequent years



Source: Global Financial Data, AMP Capital Investors

Australian shares – extreme falls are often followed by extreme rebounds in subsequent years

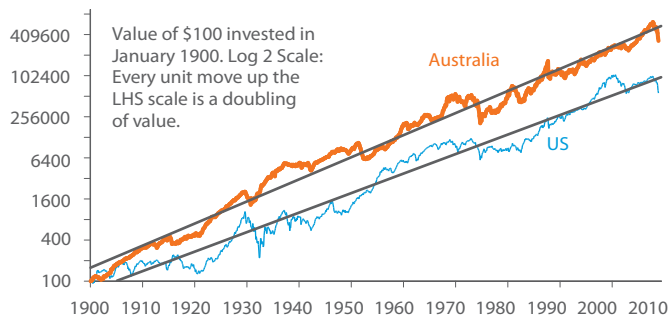


*As at 27/11/08. Source: Global Financial Data, AMP Capital Investors

From above to well below trend

The extreme bear market over the last year has also taken shares well below their long-term trend. The following chart shows cumulative real return indices for both US and Australian shares against their long-term trend. They show the value of \$100 invested in US shares and Australian shares in 1900, with dividends reinvested along the way and after the impact of inflation. Over the whole period, the \$100 (in today's dollars) invested in 1900 would have grown to \$330,768 in Australian shares today.

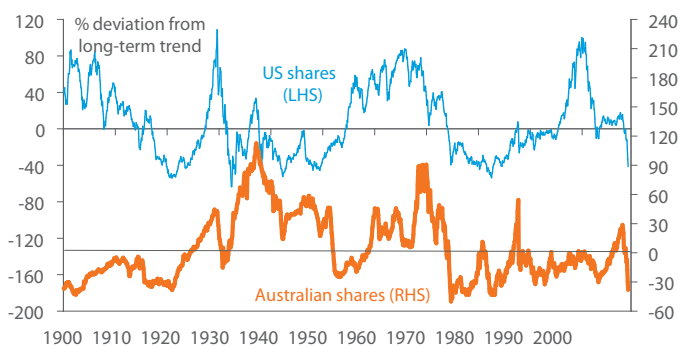
US and Australian shares markets – cumulative real return indices



Source: Global Financial Data, AMP Capital Investors

The bear market over the last year has taken returns to well below trend. This is indicated in the following chart, which shows that the real return index from Australian shares is now 37% below trend, and that from US shares is now 39% below trend. History tells us that they normally don't fall much further below trend from current levels and that they either track sideways, or rebound.

US and Australian shares – cumulative real return index, deviation from trend

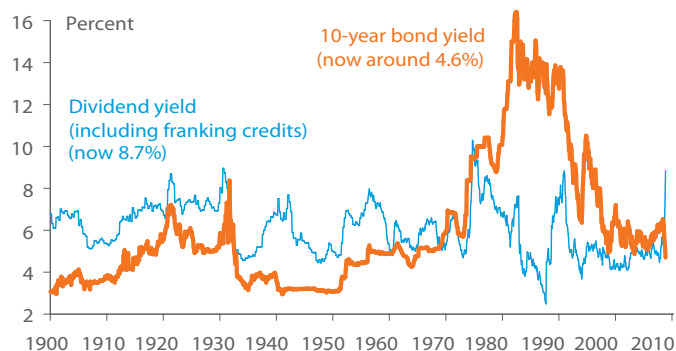


Source: Global Financial Data, AMP Capital Investors

Long-term valuation measures are cheap

Shares are now also attractive from a long-term valuation perspective. One way of looking at this is to look at the dividend yield. Dividends are a useful way to value shares over the long term, as they are relatively stable since companies like to maintain a smooth profile for dividends over time. Right now the dividend yield on Australian shares adjusted for franking credits is 8.7%, which is about as high as it has ever been. It is well above the 10-year bond yield of 4.6% for the first time since the mid-1970s. So, even before capital gains shares are now providing a higher cash flow return than bonds.

Australian shares – dividend yield is now well above the bond yield

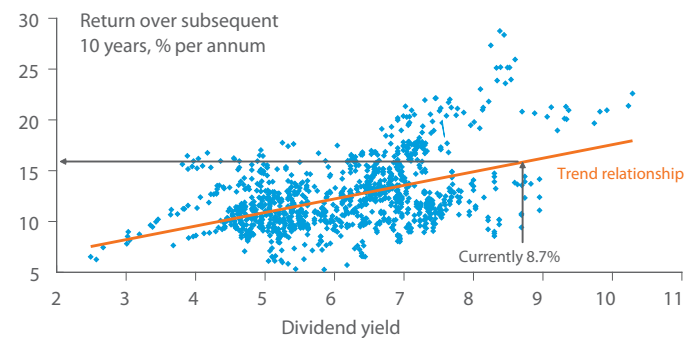


Source: Global Financial Data, AMP Capital Investors

The current high level for the dividend yield is a direct result of the collapse in the share market due to uncertainty about future earnings and dividends. But when the dividend yield has been pushed up to this sort of level in the past, the return from Australian shares has tended to be well above average over the subsequent ten years. This is illustrated in the following chart which maps the dividend yield at any point in time against the return from shares over the subsequent 10 years, using data from 1900 to the present. For example, when the dividend yield (horizontal axis) is 4%, the rising trend line indicates

that subsequent 10-year returns have averaged around 9% per annum (vertical axis). But when the dividend yield is 8%, subsequent 10-year returns have averaged around 15% per annum. The grossed up dividend yield is currently 8.7%.

Australian shares – higher dividend yields normally result in higher returns



Source: Global Financial Data, AMP Capital Investors

But aren't dividends about to collapse?

At this point, a sceptic would argue that I have used a dividend yield based on dividend payments over the last year, and blind Freddie knows they are about to be slashed as profits fall. Yes, dividends are likely to fall over the year ahead, but several points are worth noting. Firstly, history tells us that just as dividends don't rise as much as earnings in the good times, they don't fall as much either in the bad times, given the desire of companies to keep them smooth over time. Secondly, and most importantly, real dividend levels also came under pressure after past historic peaks in the dividend yield such as in 1930, 1974 and 1990. But the 10-year average return from Australian shares after these peaks was 14.2% per annum (or 14.3% per annum in real terms) in 1930, 22.6% per annum (or 11.9% per annum in real terms) in 1974 and 13.6% per annum (or 10.9% per annum in real terms) in 1990. This was well above the average return from Australian shares of 11.9% per annum since 1900 (or 7.7% per annum after inflation). The point is that it is the slump in share prices that now makes shares attractive from a long-term perspective. They have already discounted a big fall in dividends over the next year or so.

Concluding comments

Long-term valuation measures are of little use in the short term given the tendency of investors to become very near-term focused, particularly in environments of great uncertainty such as the present. But they do suggest that shares are attractive from a very long-term perspective. As Warren Buffet observed last month when buying US shares: "I am unsure as to where shares will be in a month's, or even a year's, time, but they look pretty good value from a long-term perspective barring a complete economic meltdown, which at this stage seems unlikely."

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